KPMG Economics

An Olympic challenge
Prospects for a soft landing vs. a recession

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The Summer Olympics provided an apt backdrop for the Federal Reserve's quest to hit its mark and achieve a soft landing. The path to a soft landing is like the path to winning a gold medal: It is paved with tears, setbacks and doubt. That is where the Fed finds itself.

Even those who pushed the Fed to hold rates higher for longer flipped their stance prior to the Fed's July meeting. "I changed my mind. The Fed needs to cut now," former New York Fed President Bill Dudley said a week ahead of the July meeting; it didn't.

Fears of a recession intensified with the release of July's employment report two days later The Sahm rule, a recession indicator was triggered. A market correction in Japan ricocheted around the world, and criticism of the Fed hit a fever pitch.

Soft landings are much like Olympic victories; they are easier to read about in record books than to accomplish. We have been here before.

The most touted soft landing is that of the mid-1990s. Former Fed Chairman Alan Greenspan set out to preempt rather than combat blistering inflation. He doubled the fed funds rate in a year. Bond markets tanked and the economy stalled out in the first half of 1995. He held rates elevated well into 1996.

Criticism for his actions spanned Capitol Hill to Wall Street. His confirmation for a third term was delayed for four months in 1996, also an election year. One headline from June 1996 screamed, "Heresy at Fed." Sound familiar?

Greenspan hoped to drive inflation to zero. The problem was that inflation measures overstated actual inflation. A zero target risked triggering deflation, something Japan proved is harder to escape than a bout of inflation.

A bump in the road

Real GDP growth surged 2.8% in the second quarter, double the pace of the first quarter. A rebound in consumer spending in response to discounting helped buoy gains. Home buying and building contracted under the weight of higher rates, while business investment moderated. Inventories were rebuilt, as companies scrambled to stock up ahead of new tariffs and threats of port strikes. Government spending rebounded, as a deal on the federal budget was reached. The trade deficit widened on a pickup in imports coming in under the wire before higher tariffs.

Real GDP is forecast to slow to a 1.6% in the third quarter. Consumers continue to spend, but with pockets of weakness among low-income households. The pent-up demand in housing is expected to take time to respond to lower mortgage rates. Business investment is expected to lose a beat in response to recession fears. Inventories will need to be drained. Government spending is expected to remain strong as the federal government rushed to spend what's left of the fiscal 2024 budget. The trade deficit is expected to narrow, as imports slow on a draining of inventories.

Real GDP is forecast to rise 2% in the fourth quarter, buoyed by the tailwind of lower rates. Consumers spending is expected to remain solid, while housing starts to feel the tailwind of lower rates. Business investment is more muted due to policy uncertainty around the election. Government spending is expected to stagnate, as little has been accomplished via the budget and the strong dollar is expected to push the trade deficit back into the red.

The Fed gets defensive. The Fed is expected to make up for July with a one-half percent cut now in September. The Fed will calibrate cuts thereafter to balance the desire to avert a recession with the need to keep inflation moving lower.

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His colleagues convinced him to rethink his strategy. Productivity growth was accelerating, while foreign competition was intensifying. Those shifts did the heavy lifting on inflation for the Fed, which allowed it to focus more on the full employment side of its dual mandate.

The Fed lifted its foot from the brakes, and tested how low unemployment could fall before triggering inflation. The longest expansion to date took root, unemployment plummeted and income inequalities narrowed. For the first time in decades, all boats seemed to rise with the tide in the late 1990s.

There are similarities with the Fed's current challenge. Productivity growth has accelerated, while a strong dollar should help to keep a lid on import prices. Given the progress already made on inflation, that should enable the Fed to lift its foot from the brake.

Powell admitted that he and his colleagues discussed the possibility of a cut in July, but opted to wait for more confirmation inflation would stay on track. I imagine there is some remorse in that decision. A soft landing is still possible, but risks of a recession have risen.

This edition of *Economic Compass* takes a closer look at the resurgence of recession fears, how far the Fed has come in its battle against inflation and what those shifts suggest about the trajectory of rate cuts. Bond yields have already dropped in anticipation of more aggressive rate cuts. The challenge for the Fed is to calm financial markets, without letting them front run rate cuts and, in so doing, undo the progress made on inflation. We now expect a one percent cut in rates by -year end, double the forecast a month ago.

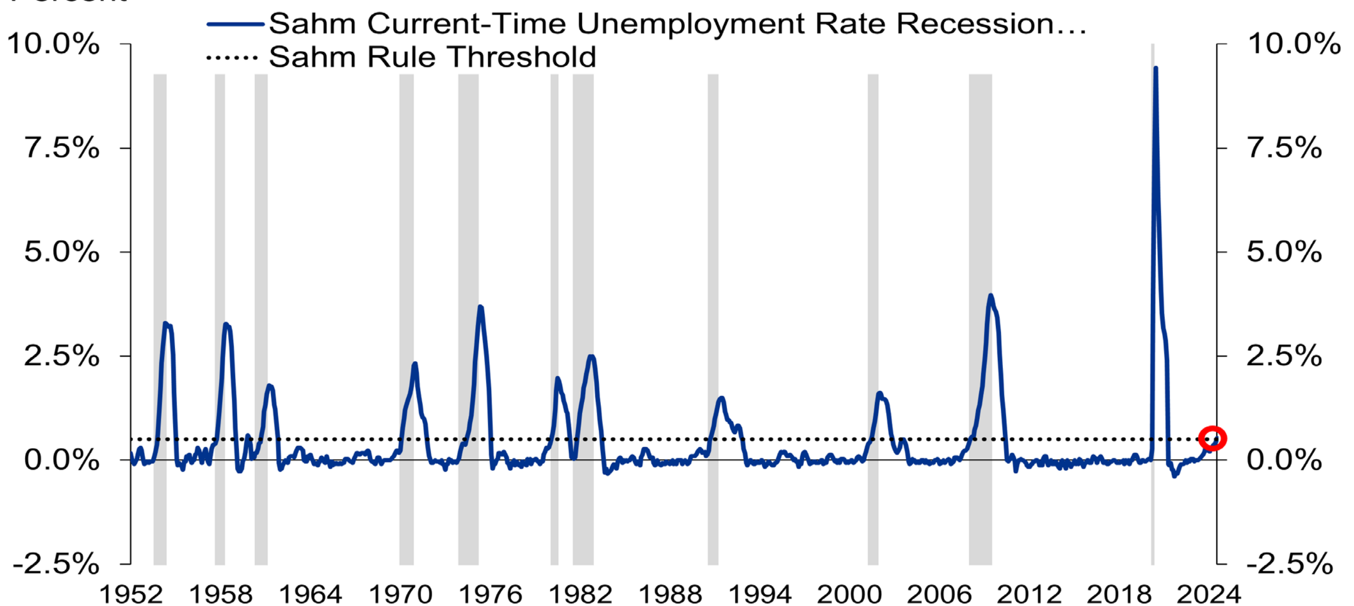
Recession risks

The Sahm Rule

Chart 1 shows the official calculation of the Sahm Rule. Once the unemployment rate moves one-half percent above its low of last year for three months, a recession has almost always followed. In July, we breached that threshold. The Sahm Rule has accurately predicted all but one recession since the 1950s; the miss was in 1976.

The largest fear for the Fed is nonlinear moves in unemployment. The unemployment rate tends to rise slowly, then more rapidly. The risk is that a vicious cycle of contracting employment and spending will take root, and push the economy into a recession.

Chart 1



Source: KPMG Economics, Bureau of Labor Statistics, Claudia Sahm (2019), Haver Analytics

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Claudia Sahm has cautioned not to read too much into the rule that bears her name. "The Sahm rule is likely overstating the labor market's weakening due to unusual shifts in labor supply caused by the pandemic and immigration," she said in a recent post.

Fed Chairman Jay Powell echoed that skepticism at the July press conference. "It is not an economic rule where it is telling you something must happen," he said. Much like Olympic records, rules were meant to be broken.

A tale of two economies

Further complicating matters is the discrepancy between the household and establishment surveys:

- The household survey shows that employment has moved essentially sideways over the last year, with only 57,000 more people employed than a year ago.
- The establishment survey shows that the economy added 2.5 million new paychecks over the same period.

That is the largest gap between the two surveys on record. Government demographers struggled to capture the pickup in immigration since the economy reopened. We are at least two years behind in counting all of those who have entered the country and filled jobs that many native-born workers wouldn't.

The fact that the economy continued to grow despite pockets of weakness makes the triggering of the Sahm Rule all the more suspect. Hurricane Beryl displaced workers in July; 461,000 were sidelined by bad weather, more than eleven times the monthly average of 41,000.

The Fed has focused more on the establishment than the household survey, as it more closely tracks other employment data:

- The ADP payroll report for private employment slowed but did not collapse in July.
- Compensation gains have cooled but remain well above the pre-pandemic pace.
- Hours worked have fallen but overall incomes are still rising faster than the pace of inflation.
- High propensity business formations – businesses with the intent to hire – remain elevated despite some moderation from the pace earlier in the cycle.
- Job openings and the Indeed job posting index have both come off their peaks hit in March 2022, but remain well above the levels hit in February 2020.
- The pace of layoffs hit a record low in late June.

Still, there are things that should worry the Fed. The ranks of the long-term unemployed have moved up, along with the number of those forced to accept part-time work when they wanted full-time.

Worse yet, the pace of hiring in the Job Openings and Labor Turnover Survey hit its lowest level in late June since April 2020. That alone could push unemployment higher, as workers entering the labor force have a harder time finding jobs. Any increases in layoffs would exacerbate those problems.

The unemployment rate for new college graduates is now rising faster than that for all college grads. The once ubiquitous signing bonuses given during the height of the hiring frenzy have all but evaporated.

The moral of the story: The Fed is now more attentive to both sides of its dual mandate: achieving price stability and full employment. It should be.

More convincing progress on inflation

The Fed has long argued that it needed to be both convinced and confident that inflation would continue to move toward its 2% target before cutting rates. It wanted to avoid the mistake that the European Central Bank made by cutting too soon only to have inflation prove stickier.

The concern has always been that the Fed would wait too long to cut, given lags in the data. The window on a soft landing has not closed, but it has narrowed. The good news is that inflation has cooled; that slowdown looks like it has legs.

Chart 2 lays out a cross section of inflation measures that the Fed watches. All of them are moving toward the Fed's 2% target. Moreover, recent shifts suggest the disinflation we are experiencing is broader and more likely to stick than the improvement we saw in the second half of last year.

Powell was careful to point out that inflation need only remain good, not continue to improve, to get to a September cut. That is due to what are known as base effects. The rapid improvement in inflation in the second half of 2023 makes for higher year-on-year comparisons; those shifts drop out of the data once we turn the corner on 2025. (See Chart 3.)

Much of the initial cooling of inflation was due to an unwinding of supply shocks, including a drop in oil prices. More recently, consumers have pushed back on price hikes, which forced major retailers and fast-food chains to start discounting again.

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Chart 2

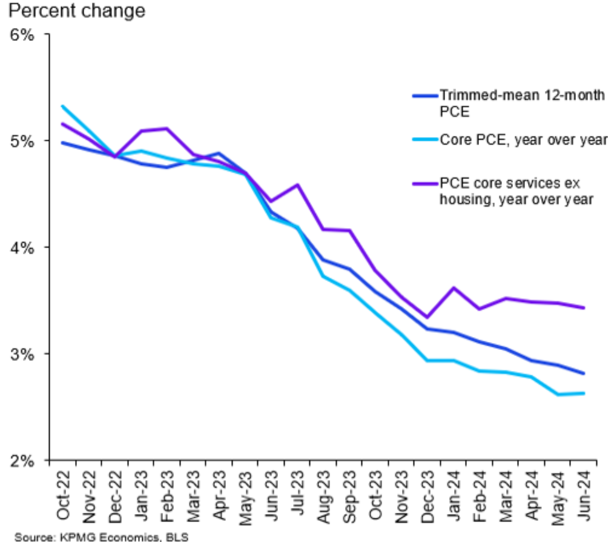
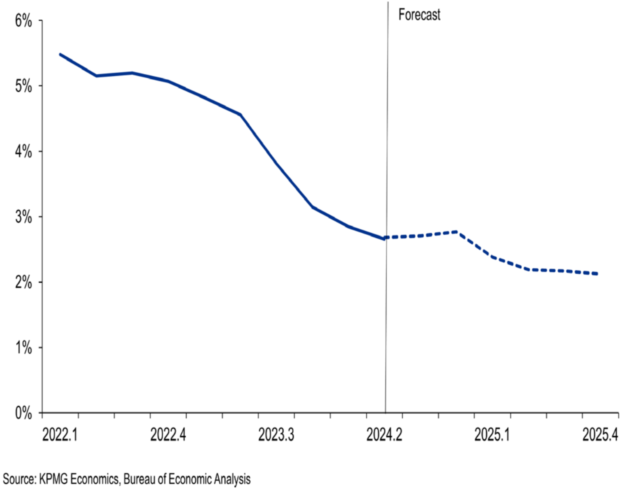


Chart 3



The question is whether that discounting can continue without squeezing profit margins. If not, layoffs could accelerate.

A productivity miracle?

Chart 4 shows the rebound in productivity growth since the onset of the pandemic. We are now above the trend hit pre-pandemic. That enables firms to better absorb higher costs and discount, without layoffs.

Why has productivity growth picked up? The pandemic acted as an accelerant, much like Y2K (look it up) in the 1990s. It prompted firms to invest and adopt existing technologies as the world pivoted online. My 84-year old mother now knows how to text and use her smart phone to read a QR code – her younger husband still has a flip phone. Still working on him.

The hiring that drove unemployment to new lows was another factor. It enabled workers to get better pay at more productive firms, while it forced recruiters to cast a wider net. They spent more time seeking workers with the right skills to fill the jobs they had open. Those shifts boosted productivity growth.

The positive effects associated with generative AI are still ahead of us. The gap between innovation and commercialization has narrowed but not disappeared. What is working for individual companies has yet to scale for the economy.

One of the greatest hurdles is the energy needed to store the data and run the large language models. It is stressing our antiquated grids along with climate change. Wind, floods and blistering heat are leaving us without power when we need it most.

Increased foreign competition

A strong dollar and excess global manufacturing capacity are expected to compound the downward pressure on goods prices. The challenge for the Fed is to recognize that before those shifts trigger layoffs.

The Institute for Supply Management manufacturing survey slumped to its lowest level in eight months in July; hiring plans hit their lowest levels since the COVID recession. Service sector indices were more mixed, but warning signals are flashing.

Implications for rate cuts

By the time the Fed has the confidence needed to cut, it may have already gone too far in keeping monetary policy restrictive. That day is quickly approaching.

Fed officials were quick to point out that the economy was not yet in a recession. They reassured that they had the tools to prevent a recession. Debate quickly shifted from if the Fed would cut in September, to how large its first cut would be.

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Chart 4

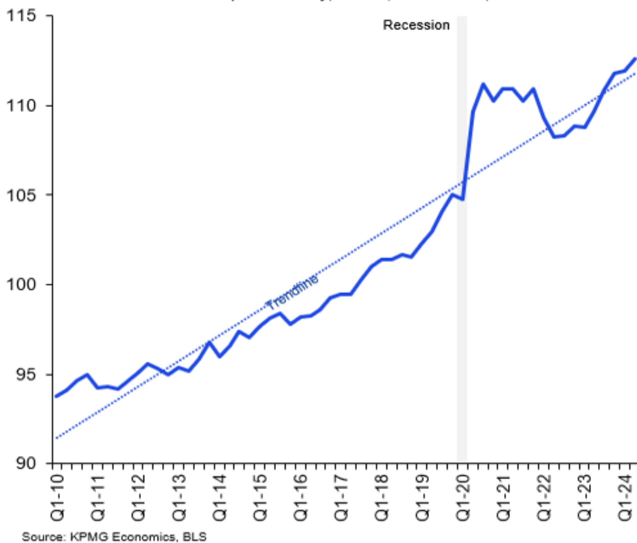
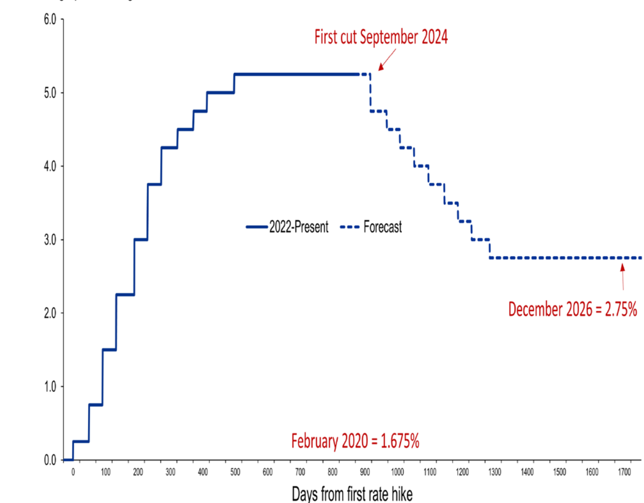


Chart 5



Powell's keynote at the Kansas City Fed's Jackson Hole Symposium on August 23 has taken on a new meaning. He needs to convey calm, without fueling further panic in financial markets. Some are looking for an inter-meeting cut; the threshold to do that is high.

Chart 5 shows our revised forecast for rate cuts. We now expect to see a 0.50% cut in September as the Fed plays catch-up. Another two 0.25% cuts are expected by year-end. That should avert a recession.

Many will see the cuts as political. Powell was adamant when queried about the influence rate cuts would have on the election at the press conference in July. "We absolutely do not do that...that would just be a line we would never cross," he said.

The challenge is to ensure the economy remains out of a recession, without reigniting inflation. The drop in bond yields we have seen since fears of recession flared will stimulate the economy ahead of rate cuts.

Rates on credit cards and consumer loans tend to fall more slowly than those for businesses. The Fed's Senior Loan Officer Opinion Survey revealed an easing of lending standards for residential mortgage loans. Homeowners have begun to tap the equity in their homes via home equity lines of credit. Remodeling is picking up.

The bond market may have gotten out over its skis on the pace of rate cuts and the panic over a harder landing. The Fed will take those shifts into account as it calibrates the pace of rate cuts after its September meeting.

External threats

A whole spectrum of risks could provoke a vicious cycle of rising unemployment and inflation. Full-scale trade wars and more frequent hot wars are possible. History has taught us that those shifts can simultaneously curb growth and boost inflation or worse, stoke stagflation. The Fed would be forced to reverse course and hike if those scenarios are realized.

Bottom Line

The Fed is still on its path to achieving a soft landing, its equivalent to winning a gold medal. It is learning just how difficult that is. It needs to get its mind as well as its body into the game. The goal is to keep the US outperforming its peers and healing pandemic-inflicted wounds. Until recently, that meant focusing solely on inflation. Now, it means balancing that focus with more attention on the labor market.

Simone Biles proved that a setback was not an end to her career. She came back triumphantly, made Olympic history and cemented her standing as the greatest gymnast of all time. The Fed has the chance to do the same by sticking a soft landing. There is no do-over for missing its mark. The whole world is watching, and in its own way, rooting for the Fed to achieve its goal. Rate cuts here influence rates elsewhere. That means when we win, other countries share in the victory.

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Economic Forecast — August 2024

	2023	2024	2025	2023:4(A)	2024:1(A)	2024:2(A)	2024:3	2024:4	2025:1	2025:2	2025:3	2025:4
National Outlook												
Chain Weight GDP[1]	2.5	2.6	1.9	3.4	1.4	2.8	1.6	2.0	1.5	2.0	1.9	2.2
Personal Consumption	2.2	2.3	2.2	3.3	1.5	2.3	2.5	2.3	2.1	2.1	1.9	2.2
Business Fixed Investment	4.5	3.7	2.4	3.7	4.4	5.2	0.8	2.5	2.3	2.5	2.3	2.3
Residential Investment	-10.6	3.5	1.7	2.8	16.0	-1.4	-7.5	-3.3	3.7	6.3	7.0	8.4
Inventory Investment (bil $ '17)	41	46	57	41	41	23	51	58	49	53	62	63
Net Exports (bil $ '17)	-937	-1000	-1050	-950	-987	-1000	-1003	-1010	-1031	-1044	-1058	-1066
Exports	2.6	2.4	3.7	5.1	1.6	2.0	3.7	3.6	3.3	4.3	4.4	4.4
Imports	-1.7	3.7	4.2	2.2	6.1	6.9	2.2	3.4	4.7	4.6	4.7	4.0
Government Expenditures	4.1	3.2	1.0	4.6	1.8	3.1	2.3	1.1	0.6	0.6	0.5	0.5
Federal	4.2	2.5	1.3	2.4	-0.2	3.9	2.9	1.2	0.5	0.8	1.0	0.9
State and Local	4.0	3.6	0.9	6.0	3.0	2.6	1.9	1.0	0.6	0.4	0.2	0.2
Final Sales	2.9	2.5	1.9	3.9	1.8	2.0	2.0	1.9	1.7	2.0	1.8	2.2
Inflation												
GDP Deflator	3.6	2.4	2.3	1.6	3.1	2.3	2.2	2.2	2.4	2.4	2.5	2.3
CPI	4.1	3.0	2.2	2.7	3.8	2.8	2.1	2.2	1.8	2.0	2.7	2.5
Core CPI	4.8	3.4	2.5	3.4	4.2	3.2	2.3	2.5	2.4	2.4	2.4	2.3
Special Indicators												
Corporate Profits[2]	5.1	7.7	2.0	5.1	6.4	12.4	10.6	7.7	9.3	4.1	2.9	2.0
Disposable Personal Income	4.1	1.4	3.2	0.9	1.3	1.0	2.4	2.5	4.2	3.4	3.3	3.4
Housing Starts (mil)	1.42	1.36	1.43	1.48	1.41	1.35	1.33	1.35	1.39	1.42	1.44	1.47
Civilian Unemployment Rate	3.6	4.1	4.4	3.8	3.8	4.0	4.2	4.3	4.3	4.4	4.4	4.3
Total Nonfarm Payrolls (thous)[3]	2936	2125	606	617	771	607	300	447	165	163	119	159
Vehicle Sales												
Automobile Sales (mil)	3.1	3.0	3.1	3.1	2.9	2.9	3.0	3.0	3.1	3.1	3.1	3.1
Domestic	2.3	2.1	2.0	2.3	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Imports	0.9	1.0	1.1	0.9	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.0
LtTrucks (mil)	12.4	12.8	12.9	12.6	12.4	12.7	12.8	13.2	12.8	12.8	12.8	12.9
Domestic	9.9	10.0	10.0	9.9	9.9	10.1	10.0	10.0	10.0	10.0	10.0	10.0
Imports	2.5	2.8	2.9	2.6	2.5	2.7	2.9	2.8	2.8	2.8	2.8	2.9
Combined Auto/Lt Truck	15.5	15.9	16.0	15.7	15.3	15.7	15.8	16.1	15.9	15.9	15.9	16.0
Heavy Truck Sales	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil)	16.0	16.4	16.5	16.2	15.8	16.1	16.3	16.6	16.4	16.4	16.4	16.5
Interest Rate/Yields												
Federal Funds	5.0	5.2	3.5	5.3	5.3	5.3	5.3	4.7	4.2	3.7	3.2	2.9
10 Year Treasury Note	4.0	4.1	3.4	4.4	4.2	4.4	4.0	3.7	3.6	3.4	3.3	3.1
Corporate Bond BAA	5.9	5.8	5.5	6.2	5.8	6.0	5.9	5.7	5.6	5.6	5.5	5.4
Exchange Rates												
Dollar/Euro	1.08	1.09	1.10	1.08	1.09	1.08	1.09	1.09	1.10	1.10	1.10	1.10
Yen/Dollar	140.5	154.6	143.0	147.8	148.6	155.9	150.0	148.0	146.0	144.0	142.0	140.0

[1] in 2023, GDP was $22.4 trillion in chain-weighted 2017 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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